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K –14 Education

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 Department of Finance

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I. Proposition 98 Overview

Proposition 98 – Information Only

Total Proposition 98 funding for K-14 education in 2004-05 is proposed at \$46.7 billion, an increase of \$768.9 million (1.7 percent) over the revised 2003-04 budget. While an increase, the level of Proposition 98 funding proposed by the Governor in 2004-05 is \$2 billion below the level required to meet the Proposition 98 minimum guarantee.

The \$768.9 million increase in Proposition 98 funding in 2004-05 is completely covered by the allocation of additional local property tax revenues to K-14 education. As indicated in Table 2, Proposition 98 General Fund revenues actually decline by \$426.3 million in 2004-05 due to an estimated net increase in property taxes of \$1.2 billion.

The net increase in property taxes under Proposition 98 is the result of three different factors:

- (1) The Governor's proposal to shift \$1.3 billion in additional local property taxes to the Education Revenue Augmentation Fund (ERAF) in order to support K-14 education;
- (2) A \$1.3 billion reduction in property taxes to K-14 education as a result of the "triple flip" financing structure to pay for the Economic Recovery Bond (pursuant to Chapter 2, Statutes of 2003, Fifth Extraordinary Session); and
- (3) An increase of \$1.2 billion in estimated local property taxes due to K-14 schools from general increases in local property tax receipts.

Table 1 Proposition 98 Summary (dollars in thousands)	2003-04 Budget Act	2003-04 Revised	2004-05 Proposed	\$ Change	% Change
<i>Distribution of Prop 98 Funds</i>					
K-12 Education	\$38,891,843	\$41,480,820	\$41,937,017	\$456,197	1.1
Community Colleges	4,623,085	4,358,857	4,678,804	319,947	7.3
Dept. of Developmental Services	11,624	10,863	10,758	-105	-1.0
Dept. of Mental Health	17,851	13,400	8,400	-5,000	-37.3
Dept. of Youth Authority	37,685	36,781	34,041	-2,740	-7.4
State Special Schools	38,017	40,302	40,302	0	0
Indian Education Centers	3,778	3,778	4,330	552	14.6
Total	\$43,623,883	\$45,944,801	\$46,713,652	\$768,851	1.7

<i>Prop 98 Fund Source</i>					
State General Fund	\$28,842,957	\$30,166,130	\$29,739,800	\$-426,330	-1.4
Local Property Taxes	\$14,780,926	\$15,778,671	\$16,973,852	\$1,195,181	7.6
<hr/>					
Total	\$43,623,883	\$45,944,801	\$46,713,652	\$768,851	1.7
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K-12 Enrollment-ADA*	5,990,495	5,978,127	6,039,207	61,080	1.2
K-12 Funding per ADA*	\$6,588	\$6,940	\$6,945	\$5	
<hr/>					
* Average Daily Attendance					
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As indicated in Table 2, of the total \$46.7 billion in Proposition 98 spending proposed for 2004-05, \$41.9 billion is attributable to K-12 and \$4.7 billion is for Community Colleges. The K-12 share of the Proposition 98 minimum funding level increases by \$456.2 million (1.1 percent) and the Community Colleges funding increases by \$319.9 million (7.3) percent. Community College funding grows at a higher rate due, in large part, to a \$200 million funding deferral from 2003-04 to 2004-05, which distorts true year-to-year comparisons in funding.

The number of students in K-12 schools, as measured by unduplicated average daily attendance (ADA), is estimated to increase by 61,080 in the budget year, an increase of 1.2 percent over the revised current-year level. Average per-pupil Proposition 98 funding is estimated to be \$6,945 in 2004-05, an increase of \$5 over the \$6,940 per pupil funding in 2003-04.

Calculation of the Minimum Guarantee

Proposition 98, a constitutional amendment passed by the voters in 1988 and amended by Proposition 111, established a minimum funding level for K-12 schools and Community Colleges. Proposition 98 funding is generally calculated as the greater of:

- Test 1 – a specified percent (approximately 34.5 percent) of state General Fund revenues.
- Tests 2 and 3 – The amount provided in the prior-year adjusted for K-12 ADA growth and an inflation factor. For “Test 2,” this inflation factor is the percentage change in per-capita personal income. For “Test 3” the inflation factor is equal to the annual percentage change in per-capita state General

Fund revenues plus 0.5 percent--used only when it calculates a guarantee that is less than that determined by "Test 2."

Proposition 98 also includes a provision allowing the state to suspend the minimum funding level for one year through urgency legislation other than the Budget Bill. (For additional detail on Proposition 98 calculations, see Attachment A.)

Revenue Shift/Educational Revenue Augmentation Funds (ERAF). The Governor proposes to shift \$1.336 billion in ERAF funding from local governments to K-14 education, which reduces the General Fund obligation to K-14 education by \$1.336 billion in 2004-05.¹ Of this amount, \$1.168 billion is shifted to K-12 programs and \$168 million is shifted to community colleges. According to the Legislative Analyst, this equates to roughly a 25 percent increase in ERAF obligations or a 10 percent decrease in local property tax revenues. Without this shift, the state would have to provide \$1.3 billion more General Fund for Proposition 98 than the Governor's budget or approximately \$869 million more from General Fund than the 2003-04 budget.

The Governor's proposed ERAF shift is assigned to Senate Budget Subcommittee #4, which currently plans to hear this budget item at its April 21st hearing.

II. Proposition 98 – Major Budget Issues

Governor's Proposition 98 Budget Proposals. The Governor proposes roughly \$1.9 billion in additional spending for K-12 schools in 2004-05. These new funds are the result of \$456 million in new Proposition 98 funds, an estimated \$1.1 billion in K-12 Proposition 98 funds "freed-up" from one-time expenditures, and \$300 million in program savings (child care reductions, program eliminations, and other program savings.)

The Governor proposes using \$1.2 billion of these additional funds to cover statutory growth and COLA for revenue limits and categorical programs. In contrast, the 2003-04 budget provides growth for revenue limits and special

¹ To balance the state budget in 1992-93 and then again in 1993-94, the Legislature and Governor Wilson permanently shifted more than \$3 billion in property tax revenues from counties, cities, special districts, and redevelopment agencies to each county's Educational Revenue Augmentation Fund (ERAF) to benefit K-14 education (K-12 schools and Community Colleges). These shifted funds reduce the state's General Fund obligation for K-14 education by a commensurate amount. In 2003-04, it is estimated that cities, counties, redevelopment agencies, and special districts will deposit \$5.171 billion into ERAF; the estimate for 2004-05 is \$5.527 billion.

education only but does not provide COLAs for any programs. The 2003-04 budget also reduces revenue limits by 1.2 percent (\$350 million).

The Governor's January 10 Budget also proposes \$730 million for various program increases in 2004-05 including: Public Employee's Retirement System (PERS) and Unemployment Insurance (UI) employer rate adjustments (\$242 million); revenue limit equalization (\$110 million); deferred maintenance (\$173 million); instructional materials (\$188 million); and high speed Internet access (\$21 million).

The Governor proposes a net increase of \$433 million in Proposition 98 funding for K-12 education alone in 2004-05. This reflects a \$612 million decrease in General Fund dollars Education in 2004-05, which is offset by a \$1.0 billion net increase in property tax revenues in 2004-05.²

Governor's Education Agreement. According to the Department of Finance, the Governor's January 10 Budget reflects an agreement with the "education community" to:

- "Rebase" (suspend) Proposition 98 in 2004-05 at a level \$2 billion below the minimum guarantee level;
- Provide approximately \$1.2 billion in funds for enrollment growth and COLA for revenue limits and categorical programs; and
- Establish priorities for Proposition 98 funding in 2004-05 and in future years. As detailed in the Governor's Budget Summary, these include:
 1. General purpose funds to restore revenue limit deficits made in 2003-04;
 2. Funds for payment of valid, deferred state mandate reimbursements; and
 3. Any remaining funds split 75 percent for general purpose apportionments and 25 percent for other State priorities.

It is unclear whether other proposals in the Governor's January 10 budget are a part of the agreement (or not), as the Legislature has not been notified of the precise elements of that agreement. It is also unclear what the specifics are for those elements of the proposal that have been generally described by the Department of Finance. Many questions remain about these proposals.

² For K-14 education (K-12 and Community Colleges) the Governor proposes a net decrease in General Funds of \$426 million and a net increase in local property taxes of \$1.2 billion in 2004-05.

Additionally, the Legislature has become aware that the Governor reached a new agreement with the education community on January 21 that will revise several augmentations originally proposed in the January 10 budget. The table below summarizes these changes, as verified by the Department of Finance.

Revisions to the Governor's Agreement for K-14 Education *

<i>Dollars In Millions</i>	Governor's Jan 10 Budget Agreement	Governor's Jan 21 Budget Agreement	Change
K-12 Equalization	110,000	82,230	-27,770
CCC Equalization	80,000	59,804	-20,196
Deferred Maintenance	173,300	0	-173,300
Instructional Materials	188,000	0	-188,000
Discretionary Growth & COLAs**	0	139,177	139,177
Deficit Reduction (Revenue Limit Funds)	0	270,089	270,089
Total	\$551,300	\$551,300	0

* Beyond the Governor's \$1.2 billion agreement for statutory growth and COLAs for revenue limits and categorical programs in 2004-05.

**Includes approximately \$86 million in growth and COLAs for community colleges apportionments and categorical programs, and \$53.1 million in growth and COLAs for K-12 categorical programs that traditionally receive growth and COLAS.

In summary, the January 21 revisions to the agreement:

- Add \$139.2 million to provide COLAs for community colleges and K-12 programs not subject to statutory COLAs;
- Add \$270 million in general purpose funding (revenue limits) in order to reduction existing revenue limit deficits;
- Eliminate any augmentations to restore funding for instructional materials and deferred maintenance; and
- Reduce augmentations for K-12 and community college equalization.

Other elements of the Governor's revised agreement alter the funding priorities outlined in the Governor's January 10 budget by adding two new priorities to the top of the list: restoration of K-12 and CCC equalization funds and restoration of deferred maintenance and instructional materials funds.

Without formal notification about all the elements of the Governor's agreement as contained in the January 10 budget, it is difficult for the Legislature to analyze the Governor's Budget. The Legislature has not received any formal budget notification of the January 21 revisions to the agreement and has been informed

that formal notification will not occur until May Revision. For this reason, the Subcommittee may wish to question the Department of Finance about the specifics of the Governor's agreement. Some questions include:

- *Does the agreement include a \$2 billion reduction to the Proposition 98 minimum guarantee regardless of changes in the level of the minimum guarantee at May Revision?*
- *The original agreement, as generally described to the Legislature, appears to have expanded to include other augmentations proposed in the Governor's January 10 budget. Beyond those identified in the chart above, what other augmentations are a part of the agreement, e.g. PERS and UI increases?*
- *Does the agreement include the shift of \$2 billion in categorical funds to revenue limits?*

Budget Issues/Actions:

1. Proposed Suspension in 2004-05.

The \$752 million increase for K-14, Proposition 98 funds in 2004-05 is estimated by the Governor to be \$2 billion below the level that would otherwise be provided under the minimum guarantee. As a result, the Governor proposes that Proposition 98 be "rebased" at a level approximately \$2 billion below the minimum guarantee, as required by law. This action would require suspension of Proposition 98 in 2004-05.

Suspension of the constitutional funding requirements of Proposition 98 requires the Legislature to approve the suspension in a bill -- separate from the Budget Bill -- with a two-thirds vote.

According to the Legislative Analyst's Office (LAO), the state is likely to save \$2 billion annually for several years under the Governor's suspension plan.

In addition, suspension would create an additional \$2 billion maintenance factor, which the Governor estimates would be repaid over the four years. According to the Department of Finance, the state will end the 2004-05 year with \$2 billion in maintenance factor funding from prior years when Proposition 98 levels were

based upon Test 3. Suspension would bring total maintenance factor to \$4 billion at the end of 2004-05.

The Governor, as a part of his January 10 agreement with the education community, proposes a number of priorities for use of maintenance factor repayment funds in 2004-05 and beyond. These priorities include: (1) restoration of revenue limit deficits (reductions and COLAs) from 2003-04; (2) funding for valid education mandate reimbursements; and (3) splitting any remaining funds -- 75 percent for revenue limits and 25 percent for other state funding priorities.

The LAO recommends that the Legislature suspend the Proposition 98 minimum guarantee for 2004-05. If the Legislature chooses to suspend, the LAO recommends that the Legislature determine the appropriate level of K-14 funding without regard to the amount of the suspension. In determining the appropriate level of K-14 funding, the LAO recommends that the Legislature balance K-14 priorities with other General Fund priorities.

The LAO notes that without suspension the Legislature will have to make \$2 billion in reductions to non-Proposition 98 programs. If the Legislature raises taxes, without suspension, most of the new revenues would go to Proposition 98.

2. Proposition 98 Settle-Up for 2002-03 & 2003-04

The Governor estimates that Proposition 98 funding for K-14 is below the minimum guarantee by \$517.8 million in 2002-03 and \$448.4 million below in 2003-04. These changes are the result of higher-than-expected state tax revenues, changes in student attendance and apportionment costs, and a shift of K-12 operating costs from 2002-03 to 2003-04, due in large part from an increase in the deferral amount of the second principal apportionment.

The Governor does not propose providing funding to meet the Proposition 98 guarantee in 2002-03 or 2003-04, nor does the Governor propose suspending Proposition 98 in 2003-04. (Suspension is an option for addressing the problem in 2003-04; it is unclear whether suspension is an option for 2002-03.)

Instead, the Governor proposes that \$966 million in funding for “settle-up” of these past-year and current-year expenditures, which are needed to meet the Proposition 98 constitutional guarantee, be “deferred” until 2006-07. The Governor further

proposes using any future funds appropriated for settle-up for one-time purposes such as instructional materials, training, and deferred maintenance.

The Governor's 2004-05 budget assumes that the Proposition 98 guarantee is fully funded at the minimum level in 2002-03 and 2003-04.

The LAO recommends that the Legislature suspend the minimum guarantee in 2002-03 and 2003-04 to eliminate \$966 million in future Proposition 98 settle-up obligations. According to the LAO if the Legislature does not suspend the minimum guarantee for 2002-03 and 2003-04, the state will be obligated to pay this \$966 million bill – viewed as a loan -- in the near future, regardless of the state's fiscal situation.

Trailer Bill Language: The Administration has not yet developed statutory language to defer Proposition 98 settle-up until 2006-07.

2. Certification of Past Years.

Background: Current law requires the Department of Education, Community Colleges and the Department of Finance to jointly certify Proposition 98 inputs and the overall appropriation level within nine months of the end of each fiscal year. (Proposition inputs include student ADA, per capital General Fund revenues, per capita personal income.)

However, the Proposition 98 appropriation has not been certified since 1994-95 – nearly eight years. While the statute is clear about the certification timeframe, the process is not being enforced. The upshot of delays in certification, according to the LAO, is to place the state at risk of increased Proposition 98 obligations for past years.

For example, the LAO indicates that changes in state population estimates from 2000 census data, lower state populations estimates in 1995-96 and 1996-97. As a result, per capita General Fund revenues increase, which in turn increase the Proposition 98 guarantee for these two years. According to the LAO these changes create a potential \$251 million obligation to the state. This potential obligation would not exist if the state had certified Proposition 98 in the timeframe required by statute.

The Governor's budget appears to tie payment of Proposition 98 settle-up to 2002-03 and 2003-04 to retiring "outstanding debts" to school districts from 1995-96 and 1996-97.

The LAO recommends that the Legislature certify – "close the books" – on Proposition 98 funding levels for the 1995-96 to 2001-02 fiscal years. This action would require budget trailer bill language.

As a part of this recommendation, the LAO further recommends that the Legislature certify the Proposition 98 calculations for these years using the state's population estimates available in the late 1990's and used to determine the state's minimum guarantee in 1995-96 and 1996-97.

In addition, the LAO suggests that the Legislature work with the Administration to develop a more definitive certification process in statute. The LAO suggests that certification be timed to occur one year after the close of the prior fiscal year (past year minus one year) in order to accommodate anticipated adjustments. Within this timeline, the LAO believes it would be ideal to certify the Proposition 98 level for a given fiscal year, prior to the start of the second following fiscal year. For example, the 2002-03 Proposition level would be certified before the start of the 2004-05 fiscal year.

4. Continuation of Deferrals.

The Governor's 2004-05 Budget proposes to continue \$1.0 billion in various K-12 programs deferred from 2002-03 to 2003-04. These deferrals were enacted last year as a part of a package of mid-year budget reduction proposals and involve a shift in second principal apportionment payments, referred to as P-2 payments, from June to July 2003. The 2003-04 Budget Act restored a net total of \$609.7 million in deferrals from previous years, which creates additional capacity for spending in 2004-05.

The Governor's 2004-05 budget also proposes using \$144.4 million in one-time Proposition 98 Reversion Account funds to restore funding for some programs subject to deferred appropriations schedules. Of this amount, \$98.1 million fully restores funding for the Targeted Instructional Improvement Grant program, which was deferred from 2003-04 to 2004-05, and \$46.3 million partially restores appropriations from the School Safety Program that were deferred from 2004-05 to 2005-06.

The LAO recommends that the Legislature gradually begin paying off deferrals and develop a repayment plan to restore all deferred funds over time. The LAO further recommends that the Legislature make it a priority to repay deferrals before funding new expenditures or programs. The LAO has identified over \$300 million in K-12 savings and \$80 million in community college savings, that could be applied to reducing program deferrals and other “credit card” debt. These reductions will be discussed at future Subcommittee hearings.

The Department of Education has raised concerns about utilizing apportionments for P-2 deferrals. Problems arise in properly estimating the amount of these apportionments for purposes of meeting a specific deferral target. In 2003-04, this contributed to unanticipated increases in the deferral amounts, which in turn had implications for Proposition 98 settle-up in that year.

In order to minimize these changes in the future, staff recommends that the LAO work with the Department of Education and Department of Finance in developing a list of alternative deferrals as substitutes for programs on the current list of deferrals.

[Budget Trailer Bill Language – See attachment.]

5. K-12 and Community College Split. The Governor proposes a Proposition 98 “split” between K-12 schools and Community Colleges for 2004-05 of **89.6** percent for K-12 and **10.4** percent for Community Colleges.

For more than a decade, current law has required a Proposition 98 funding split between K-12 and Community Colleges of approximately 89 percent versus 11 percent. This split is based upon the percentage of Proposition 98 funding received by K-12 schools and Community Colleges in 1989-90. This statutory “split” has been suspended by the Legislature for more than ten years (since 1992-93) to reflect actual spending percentages.

The LAO recommends that the Legislature annually adjust the funding share to reflect its budget priorities relative to current circumstances.

[Budget Trailer Bill Language – See Attachment.]

III. Enrollment Growth & Cost-of-Living Adjustments (COLA's)

The Governor's January 10 Budget proposes \$1.2 billion to fund enrollment growth and COLAs for revenue limit and categorical programs. The Governor's January 10 Budget does not include COLAs for some categorical education programs that are not required by statute to receive COLA's. The Governor's January 21 education agreement proposes another \$53.1 million to fully fund growth and COLA's for all K-12 education programs that traditionally receive a COLA.

In comparison, the 2003-04 (current year) budget provides growth funding for revenue limits and only one categorical program (special education), and does not fund COLAs – estimated at 1.8 percent -- for any education programs. In addition, the 2003-04 budget reduces revenue limit funding generally by 1.2 percent.

Budget Issues/Actions:

1. Enrollment Growth Funding. Enrollment growth for K-12 education is estimated to grow by 1.02 percent in 2004-05, which is notably lower than the year-to-year rate over the last decade when rates averaged 2.2 percent according to the LAO.

Over the next five years, K-12 enrollment growth rates overall are predicted by the Department of Finance to fall to zero. In fiscal year 2008-09, overall K-12 enrollment is expected to decline. This trend reflects the loss of children born to “baby-boomers” who are aging out of the K-12 schools.

The Governor's Budget provides \$406.2 million to fully fund enrollment growth for revenue limits and categorical programs subject to statutory growth adjustments in 2004-05. Of this amount, the budget provides \$279.8 million for revenue limits; \$37.4 million for special education; and \$89 million for other categorical programs.

The Department of Finance will update enrollment growth estimates as part of the Governor's “May Revise” to reflect population updates, as well as, revisions to the Governor's January 10 education agreement.

2. Cost-of-Living Adjustments (COLAs). The Governor's Budget proposes \$742.4 million to fully fund statutory COLAs for K-12 revenue limit and categorical programs in 2004-05. This provides a 1.84 percent COLA for revenue

limits (\$554.8 million); special education (\$70.0 million); and other categorical programs (\$117.6 million) that require a COLA pursuant to state statute.

The Department of Finance will update COLA estimates as part of the Governor's "May Revise" to reflect inflation updates, as well as, revisions to the Governor's January 10 agreement.

3. Deficit Factor

Background: The Legislature has approved deficit reduction funding for revenue limits in years when the statutory COLA has not been fully provided. This was the case during the recession years of the early 1990's when the statutory COLA for revenue limits was not fully funded. As a result, the state created a second set of revenue limits, called "deficited" revenue limits. Deficited revenue limits reflect the amount that the state actually provides to school districts and county offices of education for revenue limits.

The state keeps track of the difference between base revenue limits and deficited revenue limits – by acknowledging through statute revenue limit deficit factor. The deficit factor specifies the amount the state owes schools by a percentage that is approved in statute as part of the annual budget package.

The 2003-04 budget provides growth funding for revenue limits, but suspended the 1.8 percent COLA for these programs. In addition, the 2003-04 budget reduced revenue limit funding by 1.2 percent. Together these actions resulted in approximately \$900 million in savings. Budget trailer bill language contained in AB 1754 (Chapter 227; Statutes of 2003) created a 3.0 percent deficit factor for these revenue limits reductions and foregone COLA's that would be restored to revenue limit calculations in 2005-06.

The Governor's January 10 Budget proposes to continue the revenue limit deficit factor in 2004-05, estimated at \$907 million. However, the Governor's January 21 agreement with the education community includes \$270 million in augmentation funds for revenue limit deficit reduction funding in 2004-05. This would reduce outstanding deficit factor to approximately \$637 million.

Budget Trailer Bill Language – See attachment

IV. Other Revenue Limit Adjustments and Increases

Budget Issues/Actions:

1. Revenue Limit Equalization.

Background: In the 1971 *Serrano v. Priest* state Supreme Court decision, the court specified a range (currently about \$335.00) to measure equality in school funding. (Approximately 98 percent of the state's pupils are funded within that range which meets the court's standards.) In the years following the *Serrano* decision, the Legislature has enacted several statutes designed to equalize revenue limits among the state's school districts.

The passage of SB 727 (Chapter 854; Statutes of 1997) by both eliminating excused absences from the revenue limit calculation—beginning with the 1998-99 school year—and increasing revenue limits to offset the effect of lower attendance, also significantly changed revenue limit levels. To some extent SB 727 also increased the variation in revenue limits and changed which districts were above and below revenue limit averages.

The LAO has advised the Legislature in recent years that without supplemental funding it will take a long time to reach equalization targets. In past years, the LAO has calculated it would take roughly 12-45 years to bring at least 95 percent of pupils to the same revenue limit.

While equalization funding was not included in the 2002-03 budget, the education budget trailer bill to that budget -- AB 2781 (Chapter 1167; Statutes of 2002) -- appropriated \$406 million for equalization in 2003-04. AB 2781 distributed funds evenly on a pre-SB 727 and post-SB 727 basis. The Governor vetoed \$203 million (half) of these funds provided for pre-SB 727 equalization, leaving \$203 million for equalization in 2003-04. AB 1754 (Chapter 227, Statutes of 2003), the education budget trailer bill to the Budget Act of 2003 later eliminated these funds.

The Governor's budget proposes \$109.9 million for revenue limit equalization in 2004-05 to address disparities in base funding among school districts.

The LAO recommends that the Legislature delete \$110 million for revenue limit equalization proposed by the Governor in 2004-05, given the state's fiscal situation. In addition, the LAO recommends that the Legislature delay revenue limit equalization and redirect funds to pay off deferrals until a year when

Proposition 98 can fund “credit card” obligations – deferrals, revenue limit deficits or unfunded state mandates.

The LAO also recommends that the Legislature adopt trailer bill language to require the Quality Education Commission to develop definitions and adequate funding levels for small schools districts of all types – elementary, unified and high school.

The LAO is concerned that the Governor’s equalization proposal focuses on bringing all districts to the 90th percentile of all size and type districts and, as a result, has the unintended consequence of resulting in different increases for districts of different sizes and types. The Quality Education Commission was established by legislation in 2002 in response to recommendations from the K-University Master Plan Commission. The Commission is charged with determining the level of school funding that would be adequate to allow students to meet state standards.

2. Revenue Limit Consolidation -- LAO Proposal

Background: In addition to base revenue limits totaling \$27.8 billion, the LAO has identified nine other major revenue limit programs. Together these nine programs account for approximately \$2 billion in state and local expenditures.

Eight of these nine programs are technically considered revenue limit “add-on” programs, meaning that if a district qualifies for the program, the state adds revenue limit funds. (In the case of the PERS offset, the state decreases district revenue limits.)

The LAO finds that except for the Minimum Teacher Salary Incentive program, all of the other revenue limit add-on programs were established in the 1970s and 1980s. Additionally, the LAO notes that each of these programs treats school districts differently, typically to reflect purposes when they were created.

In searching for revenue limit add-on programs that would be good candidates for being folded into base revenue limits, the LAO assessed programs to determine if they truly provided general purpose funding or if all districts (or nearly all) districts participated in the program.

The LAO identified six revenue limit add-on programs that met either of these tests. These six programs, and funding associated with them, include:

1. Meals for Needy Pupils (\$126.8 million);
2. SB 813 Incentive Programs (\$1.2 billion);

3. Interdistrict Attendance (\$.5 million);
4. Continuation Schools (\$34.4 million);
5. Unemployment Insurance (\$212.2 million); and
6. PERS Offset (-\$10.3 million).

The LAO recommends that the Legislature revise the system of district revenue limits by merging funding for these six “add on” programs into a single general purpose grant. Together these programs provide nearly \$1.6 billion in revenue limit funding. According to LAO, this proposal would simplify the computation of general purpose funding, make it easier to understand, and include additional general purpose revenue limit funds in equalization adjustments over time. Including these additional funds would provide a fairer picture of general purpose revenue limits actually received by districts and, according to the LAO, result in a more uniform distribution of funds among school districts.

Staff believes the LAO proposal has merit and would recommend that the Subcommittee give this proposal serious consideration as a part of joint hearings with Senate Education Committee. Staff further suggests that the Subcommittee consider revenue limit consolidation prior to providing augmentations for revenue limit equalization. Staff also suggests that that revenue limit consolidation might also be an appropriate issue for the Quality Education Commission to address in the coming year.

7. Public Employees Retirement System (PERS) – Local Contributions & Revenue Limit Offset

Background: The state adjusts funding to school districts and county offices of education agencies for their employer contributions to PERS through a complicated formula referred to as the PERS Revenue Limit Offset. This makes discussion of state funding to cover PERS costs to local education agencies less than straightforward.

School districts and county offices of education make employer contributions to PERS for their classified (non-credentialed) employees. Under current law (Education Code 42238.12) each school district's base revenue limit is adjusted by the difference between the PERS employer contribution rate in 1981-82 (13.02 percent) and the school district's current employer contribution rate. The idea of the

PERS offset was for the state to capture some of the savings that accrued to districts when PERS rates fell below the historically high rate of 13.02 percent in 1981-82.

The way the offset works is that when the PERS contribution rate is below 13.02%, this reduces the district's revenue limit funding, which reduces (or offsets) state General Fund costs. As the PERS contribution rate rises, state General Fund costs increase due to a reduced revenue limit offset. As the PERS contribution rate drops, state General Fund costs decrease due to an increased revenue limit offset.

Since the PERS revenue limit cap is set at 13.02 percent, if the PERS rates climb above this level the state will have to start paying directly for local education agency contributions above this level.

As indicated by the chart below, PERS employer contribution rates have been volatile in recent years, as a result of changes in the rate of return on PERS investments that offset employer contributions. While the current rate is 12.2 percent, the rate was zero percent from 1998-99 to 2001-02. In these years the state fully offset PERS employer contribution costs to local education agencies.

	PERS Contribution Rate (Percent)	Amount of PERS Offset (Dollars in millions)
2001-02	0	628
2002-03	2.894	545
2003-04	10.42	143
2004-05	12.02	10

The Governor's Budget provides an increase of \$106.0 million in revenue limit funding to cover PERS rate increases for school districts and county offices of education. The PERS school employer contribution rate is estimated to increase from a 10.4 to 12.2 – a total of 1.8 percent in 2004-05. This reduces the PERS revenue limit offset to school districts and increases state General Fund costs by \$106 million, to a total level of approximately \$10 million.

The Governor's Budget also recommends removing the 13.02 percent cap on the PERS offset and has developed budget trailer bill language to make that change. The removal of the cap will limit General Fund costs if PERS rates climb above 13.02 percent.

The LAO recommends eliminating the separate PERS revenue limit offset as a part of its proposal to consolidate revenue limit programs (see Section IV-3 of this

agenda). According to the LAO, virtually all districts take a reduction in revenue limits under the PERS offset adjustment. If it were eliminated, it would make more general purpose funding available to local educational agencies. This would reduce savings to the state however.

If the Legislature does not adopt revenue limit consolidation, the LAO would support removal of the cap, as it would result in substantial state General Fund savings if PERS rates grow above 13.02 percent.

4. PERS Revenue Limit Offset Mitigation.

Background: Another state law has a fiscal affect on PERS revenue limit calculations. SB 6 (Chapter 794, Statutes of 2001) was enacted to mitigate losses to revenue limits for local education agencies that result from annual changes in the PERS employee contributions. Under this measure, local education agencies receive a share of mitigation funds appropriated in the budget proportionate to their share of the total statewide offset. The measure limits the level of PERS mitigation to \$35 million adjusted annually for COLA.

As mentioned in the section above, the PERS revenue limit offset statute passes through to the state all savings or costs that otherwise would accrue to K-12 agencies from annual changes in the employer contribution rate. SB 6 was enacted in 2001, when PERS employer contribution rates were zero. In this situation, the savings calculation requires local agency apportionments to be reduced by the full 13.02 percent of the salaries of their PERS employees. SB 6 sought to mitigate these reductions in revenue limits.

SB 6 was negotiated as a part of the 2001-02 Budget Act. As a result, that budget provided \$35 million in revenue limit funds for local education agencies in the form of a PERS revenue limit offset mitigation pursuant.

The Governor vetoed the \$36 million augmentation the Legislature provided for PERS offset mitigation in the 2002-03 Budget Act, but restored \$35 million for the program in the 2003-04 Budget Act.

The Governor's 2004-05 Budget continues \$36 million in funding for PERS revenue limit offset mitigation pursuant to Chapter 794; Statutes of 2001.

The LAO recommends elimination of the PERS revenue offset as a part of its revenue limit consolidation proposal, which would eliminate the need for PERS offset mitigation. Last year the LAO recommended delaying additional funding for PERS offset mitigation until the state is able to fully fund growth, COLA and pay off program deferrals.

Budget Trailer Bill Language – See attachment.

5. Unemployment Insurance (UI)

Background: Current law requires the state to directly cover the costs of UI rate increases that exceed local education agency costs in 1975-76.

The Governor's Budget proposes \$136.0 million in additional revenue limit funds to fully fund estimated increases in local education agency UI costs in 2004-05. According to the Department of Finance, UI rates have more than doubled – increasing from 0.3 percent in 2003-04 to 0.7 percent in 2004-05. These increases are attributed to increased benefit amounts and longer eligibility periods that are tied to staff reductions.

The LAO recommends that funding for UI rate increases be folded into base revenue limits pursuant to their revenue limit consolidation proposal. Under this proposal funding for six revenue limit “add-on” programs, including UI Reimbursements, would be merged into base revenue limits, and cease to exist as separate revenue limit programs.

6. Basic Aid Funds.

Background: For most of California's 983 school districts, revenue limit income is derived from both local property taxes and state funds. Last year there were 82 California school districts with local property taxes that nearly equal or exceed the revenue limit amount, so they require little or no revenue limit funding from the state. However, because the State Constitution guarantees some “basic aid” funding for all school districts -- until 2003-04 -- received \$120 per student (or minimum \$2,400 per district) from the state.

The 2003-04 budget eliminated \$17.8 million in Basic Aid funding (\$120/ADA) to high property value districts that receive more property tax revenue than is needed to fully fund their revenue limits. As a part of this reduction, the state counts categorical funds for these districts in order to satisfy its constitutional obligation to

provide at least \$120/ADA in Basic Aid. The loss of these funds reduces general purpose funding to basic aid districts by an estimated 2.5 percent.

Of the 82 districts that received Basic Aid funding last year, there were 60 districts that received an equal amount or more local property taxes than needed to fund their revenue limits. According to the Department of Finance, there are now 74 of these schools districts --deemed excess property tax districts – although the number can fluctuate each year, depending on the level of property taxes and the number of students enrolled in their district.

According to the Department of Finance (DOF), total excess taxes are estimated at \$180 million in 2003-04 and \$191 million in 2003-04. The Governor's 2004-05 budget estimates excess property taxes at \$201 million, or 5.2 percent above the \$191 million projected in 2003-04. It is estimated that the 2004-05 estimates will be higher when new property tax figures are released at May Revise.

The 2003-04 budget made two separate reductions for Basic Aid districts. These reductions total \$27.6 million and include:

- \$17.8 million to eliminate Basic Aid funding (\$120 per ADA) and satisfy the constitutional obligation to provide state Basic Aid through the provision of categorical funds to these districts; and
- \$9.9 million to further reduce funding for Basic Aid districts whose property taxes exceed their revenue limits (excess property tax districts) and therefore do not receive any revenue limit funding from the state. This action further reduces categorical funding by up to 3 percent of each district's calculated revenue limit.

The second reduction -- \$9.9 million for excess property tax districts – was developed as a method of assessing the revenue limits reductions in the 2003-04 budget to basic aid districts. These districts received little or no revenue limits from the state and therefore avoided the 1.2 percent reduction and 1.8 percent in foregone COLAs for revenue limits that were felt by most districts in the state.

The Governor's Budget continues the elimination of Basic Aid funding in 2004-05, which resulted in a reduction of \$17.8 million for approximately 82 districts. As required by budget trailer bill language tied to the 2003-04 budget, this reduction was structured to be ongoing.

The Governor's Budget does not continue the additional \$9.9 million reduction for approximately 74 excess property districts and therefore restores this funding for

these districts in the 2004-05 budget. The rationale for this action is that the 2003-04 budget trailer bill established this reduction for one year only.

The LAO recommends that the Legislature reduce the \$9.9 million in funds proposed to restore categorical funding to basic aid districts until the state restores the 3 percent revenue limit reductions to other K-12 school districts. (It should be noted that the Governor proposes \$270 million to restore revenue limit reductions as a part of the latest education agreement.) This action would require trailer bill language.

V. Other Categorical Program Adjustments and Increases

Budget Issues/Actions:

1. Deferred Maintenance

Background: The state Deferred Maintenance program provides state and local funding for major repair or replacement of school facilities. The State Allocation Board allocates funds to applicant local school districts, which are required to fully match state dollars in order to participate in the program.

Deferred maintenance, which is different from routine maintenance, is defined as the repair or replacement work performed on a school facility that is not performed on an annual, ongoing basis, but is planned for the future and part of each district's five year plan. According to the LAO, projects include major maintenance and infrastructure projects such as exterior painting, roof replacement, and long-term repairs to electrical, heating and plumbing systems.

AB 1124 (Nunez) (Chapter 358, Statutes of 2003) makes assurance of clean and functional school facilities, including restroom facilities for pupils, a priority use of deferred maintenance funds. This new statute does not allow deferred maintenance funds to be used for regular and operational maintenance costs of restrooms or other facilities. Under this new statute, clean is defined as meeting local hygiene standards applicable to public facilities.

The Governor's Budget proposes to restore \$173.3 million for the Deferred Maintenance program in 2004-05. This increase will bring total funding to \$250.3 million, which fully funds the program at the level required in statute. The 2003-04 budget reduced funding for Deferred Maintenance by \$128.7 million.

The LAO recommends adding the \$250.3 million proposed for Deferred Maintenance in 2004-05 to the Governor's proposal to consolidate \$2 billion in categorical programs into revenue limits. The LAO believes that the state's emphasis on deferred projects creates an incentive for districts to defer projects rather than focus on ongoing maintenance. The LAO also believes that local maintenance incentives have become stronger since 1998 due to new requirements in the state bond acts. In addition, the LAO believes that because deferred maintenance counts as a part of the 3 percent of their budgets districts must spend on maintenance, the program does not actually increase local spending on maintenance.

2. Instructional Materials

The Governor's January 10 Budget provides an additional \$185 million to restore funding for the Instructional Materials Block Grant in 2004-05. Funding for this program decreased by \$75 million in 2003-04 -- from \$250 million to \$175 million. The intent of this new funding is to purchase textbooks from the 2002 English Language Arts adoption and the 2005 History and Social Science adoptions.

The \$185 million increase proposed by the Governor, together with \$175 million in existing instructional materials funds, brings total funding to \$363 million in 2004-05. However, the Governor's January 10 Budget also proposes to shift the \$175 million in existing Instructional Materials Block Grant funds to revenue limits as a part of the Governor's categorical program consolidation proposal.

The net effect of these actions is to increase funding for revenue limits by \$175 million and increase special or dedicated funding for instructional materials by \$10 million.

The Governor's January 21 education agreement eliminates the \$188 million in new funding for instructional materials in 2004-05. If the Governor stands by the January proposal to shift \$175 million in remaining funds to revenue limits, there would not be any dedicated funding for instructional materials in 2004-05.

The LAO recommends restoring instructional materials to \$250 million in 2004-05 -- an increase of \$75 million. However, the LAO recommends shifting all of these

funds to revenue limits, as a part of the Governor's categorical consolidation proposal.

The LAO believes that \$250 million provides adequate funding for purchase of English Language Arts materials and to pilot –rather than purchase – history/social science materials in 2004-05. The LAO believes that the Governor's proposal does not consider that many school districts "banked" instructional materials funds for the last two years in order to purchase 2002 English Arts adoptions, which are fully aligned to state standards. For this reason, the LAO also recommends reducing the Governor's January 10 budget augmentation to \$75 million – a savings of \$113 million.

The LAO does not have a recommendation on the Governor's January 21 education agreement, as the Legislature has not received budget notification of any revisions to the Governor's January 10 budget.

3. Educational Technology – Higher Speed & Capacity Internet Access

Background: The Governor's Budget would create a new state categorical program that would provide new, ongoing funds to school districts and county offices of education to purchase access to a higher speed, higher capacity internet system known as Internet 2. Developed initially by 34 universities, Internet2 now serves 200 universities across the country.

The University of California and California State University systems, as well as, independent universities in California currently use Internet2.

Over the last four years, the California Digital Project has spent \$95.5 million to extend this university network to the K-12 school system. The project was funded through the University of California (UC) budget, as summarized on the chart below.

California Digital Project -- Funding History

<i>Dollars in millions</i>	2000-01	2001-02	2002-03	2003-04	2004-05
University of California	32.0	27.2	22.0	14.3	0
California Department of Education					21.0

Through a contract with the Corporation for Education Network Initiatives in California (CENIC), the California Digital Project at UC has extended Internet2 access to 58 county offices of education, 82 percent of school district offices, and 71 percent of schools.

The primary benefits of the system are to provide: (1) higher speed service, (2) additional capacity for transmitting video, complex images and large amounts of data, and (3) a private system that is more secure and eliminates advertising.

The system is intended to provide new resources to enrich curricula, as well as, to provide innovative teaching and learning experiences for students and educators. Through enhanced video streaming services the K-12 schools can improve student access to curriculum by providing online instruction. For example, Advanced Placement courses can be offered to students in schools that currently don't have access to these courses. In addition, Internet2 can provide additional capacity for on online degree programs and professional development programs developed collaboratively between K-12 and higher education systems.

The Governor's Budget proposes \$21 million for a new, ongoing state categorical program to fund Internet2 access for school districts and county offices of education. This proposal would end four years of funding in the University of California budget - totaling \$95.5 million - that has been used to establish Internet2 connections to all 58 county offices of education.

School districts must fund their own connections to county offices of education. Reportedly, 82 percent of school district offices and 71 percent of schools -- representing 4 million students -- have paid for these connections.

LAO recommends that the \$21 million in funding for this high-speed internet access program be deleted, as the program has limited benefits to schools and school districts and the technology is still relatively expensive.

Staff notes that while the state has invested considerable resources in the development of Internet2 services for K-12 schools and the goals of the project are laudable, it is not clear why a new, ongoing state categorical program is needed. If there are benefits and savings to schools districts, it seems that school districts should fund these services. With approximately 983 school districts and 58 county offices of education, the costs to districts would average \$20,000, although staff notes costs to individual districts, such as rural districts, could be higher, or in other districts possibly even lower. These costs might be offset by any savings that accrue to districts. In addition, there may be other sources of public funding that school districts can access to cover these costs. Staff recommends that the LAO explore the savings associated with this proposal and other possible funding sources for Internet2 and report back to the Subcommittee at its May 17th hearing.

8. Other Increases

In addition to major increases identified in this Subcommittee agenda, the Governor's 2004-05 Budget proposes another \$85.6 million in program increases. According to the LAO, most of these are technical increases as indicated below.

Program	2004-05 Increase (Dollars in millions)
CTC Intern Program	2.387
Child Nutrition	4.887
High Priority Schools	2.847
Other Technical Adjustments	75.455
Total, Other Increases	85.576

VI. Program Savings & Reductions – Information Only

As summarized by the LAO, the Governor's Budget proposes approximately \$1.5 billion in program decreases, which are summarized below:

Program	2004-05 Decreases (Dollars in millions)
Net reductions for P-2 Deferrals	1,036
Proposition 98 Reversion Account Swap	146
Program	2004-05 Increase

	(Dollars in millions)
Special Education Federal Fund Offset	74
Combined Child Care Proposals	69
Immediate Intervention/Underperforming Schools Program	46
Elimination of Seven Categorical Programs	32
High Priority Grants	28
STAR - NRT Reductions	6.5
Department of Mental Health Grants	5
Other Technical Adjustments	61.5
Total, Decreases	1,505

The majority of these reductions involve funding deferrals and shifts, as well as natural savings and technical (workload) adjustments. Some of these items are included in this agenda. Other items will be discussed at future hearings.

The Governor also proposes some true reductions in programs. For example, the Governor proposes to end funding for seven small categorical programs for a total savings of \$32.6 million in 2004-05. These programs, which will be discussed more fully at the Subcommittee's April 12th hearing, include:

- Teacher Credentialing Pre-Internship (\$8.0 million)³;
- Charter Schools Facilities Grant (\$7.7 million);
- Local Arts Education Partnerships (\$6.0 million);
- Academic Improvement and Achievement (\$5.0 million);
- Early Intervention for School Success (\$2.2 million);
- Healthy Start (\$2.0 million); and
- School-to-Career (\$1.7 million).⁴

In addition, the Governor proposes \$69 million in reductions to child care programs, which will also be discussed in detail at the Subcommittee's May 10th hearing.

³ The Teacher Credentialing Pre-Internship program is administered by the Commission on Teacher Credentialing.

⁴ The Governor proposes to end seven small categorical programs for a total savings of \$32.6 million in 2004-05. These programs include: Teacher Credentialing Pre-Internship (\$8.0 million)⁴; Charter Schools Facilities Grant program (\$7.7 million); Local Arts Education partnerships (\$6.0 million); Academic Improvement and Achievement (\$5.0 million); Early Intervention for School Success (\$2.2 million); Healthy Start (\$2.0 million) and School-to-Career (\$1.7 million).

Attachment A

Proposition 98 Guarantee

Figure 3

Proposition 98 at a Glance

Funding “Tests”

Proposition 98 mandates that a minimum amount of funding be guaranteed for K-14 school agencies equal to the greater of:

- A specified percent of the state's General Fund revenues (Test 1).
- The amount provided in the prior year, adjusted for growth in students and inflation (Tests 2 and 3).

Test 1—Percent of General Fund Revenues

Approximately 34.7 percent of General Fund plus local property taxes.

Requires that K-12 schools and the California Community Colleges (CCC) receive at least the same share of state General Fund tax revenues as in 1986-87. This percentage was originally calculated to be slightly greater than 40 percent. In recognition of shifts in property taxes to K-14 schools from cities, counties, and special districts, the current rate is approximately 34.7 percent.

Test 2—Adjustments Based on Statewide Income

Prior-year funding adjusted by growth in per capita personal income.

Requires that K-12 schools and CCC receive at least the same amount of combined state aid and local tax dollars as was received in the prior year, adjusted for statewide growth in average daily attendance and inflation (annual change in per capita personal income).

Test 3—Adjustment Based on Available Revenues

Prior-year funding adjusted by growth in per capita General Fund.

Same as Test 2 except the inflation factor is equal to the annual change in per capita state General Fund revenues plus 0.5 percent. Test 3 is used only when it calculates a guarantee amount less than the Test 2 amount.

Other Major Funding Provisions

Suspension

Through urgency legislation other than the budget bill, the Legislature may suspend the minimum guarantee, providing K-14 education any funding level consistent with Legislative priorities. The difference between the guaranteed amount and the level provided is added to the “maintenance factor,” discussed below.

Restoration (“Maintenance Factor”)

Following a suspension or Test 3 year, the Legislature must increase funding over time until the base is fully restored. The overall dollar amount that needs to be restored is referred to as the maintenance factor. A portion of the maintenance factor is required to be restored in years the General Fund grows faster than personal income.

Source: Office of the Legislative Analyst, *Analysis of the Budget Bill, 2004-05*.